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SUBJECT: CONSTITUTIONAL COURT RULING THROWS MONKEY WRENCH
INTO TURKISH BUDGET, IMF REVIEW

REF: A. (A) ANKARA 4551
B. (B) ANKARA 4480

¶1. (SBU) Summary: The Turkish Constitutional Court this afternoon annulled an additional tax on motor vehicles, potentially creating a \$780 million budget hole just as the government was moving to fill a \$1.65 billion fiscal gap as

part of an agreement with the IMF. It is not clear yet whether this decision will stick (i.e. is final), whether it could prompt challenges to other GOT fiscal measures, or how it will affect the IMF's Fifth Review. Earlier in the day, IMF ResRep had told us that he expected the GOT to complete the remaining prior actions for the Fifth Review this week. He also had identified key issues for the Sixth Review, notionally scheduled for October, to include keeping on track on the fiscal side (including the 2004 budget), agreeing on language for direct tax reform legislation, parliamentary approval of the Public Financial Management Law, and further progress on reducing redundant State Economic Enterprise workers. End Summary.

¶2. (SBU) The Constitutional Court this afternoon annulled an additional tax on motor vehicles that the GOT had imposed earlier this year. The government had expected to collect some TL 1.1 quadrillion (\$780 million) in revenues through this measure this year, so the court's decision potentially creates a substantial hole in the budget. It comes just as the GOT had agreed to implement additional fiscal measures to close a TL 2.3 quadrillion gap identified in discussions this month with IMF staff. The court, which was acting in response to a suit brought by the opposition CHP party, decided not to annual additional taxes on property.

¶3. (SBU) IMF ResRep and GOT officials with whom we spoke tonight were scrambling to gauge the impact of the decision. ResRep said the first question is whether this decision will stick (i.e. is final) and, if so, whether it will affect the nearly TL 400 trillion the government has already collected via the tax. The second is whether it will prompt legal challenges to other fiscal measures, potentially creating a larger fiscal gap. The third, assuming the decision stands, is how the GOT will fill the resulting gap, and how this process will affect timing for the Fifth Review. Although the Court has not made public its reasoning, one Istanbul analysts speculates that its concern had to do with legal process, in which case the government could reintroduce the additional tax via separate legislation.

¶4. (SBU) Earlier in the day, before the Court's decision, IMF ResRep had provided us with further details on Fund-GOT discussions and the just-concluded LOI. He noted that the fiscal gap was TL 2.3 quadrillion (not TL 2.5 quadrillion, as previously reported), including the projected budget cost of recent public sector pay hikes. He largely confirmed -- with a few amendments -- the Finance Ministry's analysis (ref B) of how the GOT would fill the gap: TL 1.2 quadrillion by continuing a partial spending freeze (mostly on investments, and including some savings from the lira's appreciation); TL 250 trillion via increasing Tekel (tobacco and spirits) prices; TL 210 trillion via an increase in the Special Transactions Tax and Educational Levy; TL 580 trillion through turning "special revenues" over to the central budget (see ref b for explanation); and TL 75 trillion through the sale of Treasury's hazelnut stock. ResRep said late today that the government had implemented all of these measures,

save the partial spending freeze, which required a Finance Minister circular (and which ResRep expects to be done in the next day or two). (Note: None of these measures required Parliament's approval. End note).

15. (SBU) The other major prior action for the Fifth Review was passage of the two remaining social security laws, covering the Bag-Kur Fund for the self-employed and the Social Security Fund. Parliament is expected to pass both pieces of legislation this week. The one outstanding issue, per ResRep, concerns the handling of social security arrears, which total some \$10 billion. Here, the GOT and Fund staff had been unable to reach agreement for months, as Fund staff insisted they could not accept anything that smacked of a general amnesty. Fortunately, a Fund technical team that came out with the latest Mission made significant progress, and Fund staff now have an agreement on principles to be inserted into the pending legislation. ResRep said this approach would preserve the net present value of the arrears by linking them to government t-bill rates, while determining the payment schedule based on a the individual's (or company's) ability to pay. ResRep expects the legislation to reflect these principles, but is watching closely to ensure there is no slippage.

16. (SBU) Given delays in other structural reforms, Fund staff has added one more prior action for this review: agreement on principles of the all-important Public Financial Management Law, which will reshape Turkey's entire budgetary process. ResRep noted that this legislation has prompted major bureaucratic disputes between the relevant ministries (and ministers), but added that a ministerial-level meeting last week had produced general agreement. One of the more difficult issues has been determining whether the Finance Minister or State Planning Organization will have the lead on implementing public investment projects. ResRep said World Bank officials want to study this question further; once they give their blessing, the Fund will consider this prior action completed.

17. (SBU) Looking ahead to the Sixth Review, ResRep said the key issues will be keeping the budget on track, including preparation of the 2004 budget; obtaining Parliament's approval of the Public Financial Management Law and legislation designed to strengthen the Banking Regulatory and Supervisory Agency's (BRSAs) ability to deal with legal challenges; and final agreement on direct tax reform legislation. On the latter, he noted that the intent of the reform was to reduce tax incentives provided to various regions and Turkey's numerous Free Zones. However, this effort was facing stiff political opposition, including from State Minister for Trade Kursad Tuzmen. The latest GOT draft actually had extended tax incentives to nearly 50 percent of Turkey's territory. Fund staff decided the best approach was to stop this version of the legislation from moving forward (they succeeded), and to bring in another technical assistance team to try to move the GOT in a better direction.

18. (SBU) Finally, ResRep reported that the government had fallen short of its end-June target of eliminating 9900 redundant positions at State Economic Enterprises (SEE's), cutting only 7400. He expressed hope that, with public sector wage negotiations out of the way, the GOT would step up its efforts and come close to reaching its 19,400 end-September target.

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